SOVEREIGN DEBT UNDER SCRUTINY. WHAT TO DO?

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Abstract

No one can deny that, nowadays, the different states of the world, developed or developing ones, have reached record levels of indebtedness. In this context, we can talk about a crisis or even some sovereign debt crises, and country risk suffered important changes.

Many specialists have made and are making significant efforts in recent years, trying to identify thresholds of indebtedness for the countries of the world, to build reliable indicators of sovereign risk, in order to make possible a kind of alert (so important in the current international context), or to show from what level onwards public debt becomes toxic and affects growth.

Relative to the impact of sovereign debt, it is clear that we already find ourselves in the field of uncertainty; of course, a high debt level is not synonymous with the disappearance of sustainability. This may, in our opinion, be analyzed correctly only on a case by case basis, taking into consideration the specificities of national economies, their performance, and the quality of economic policy measures.

Therefore, can we achieve growth in the context of a significant debt? Default risk can be controlled without resorting routinely to restructuring? What relevant indicators of sovereign risk can be used by an investor or a bank? Here are some interesting questions to which economists must answer.

Key words: *sovereign debt, sovereign risk, default, economic growth, sustainability, governance.*

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1. SOVEREIGN DEBT – GENERAL ASPECTS

The current context, of excessive debt, often puts sovereign debt in a very bad light. As a consequence, the concept is often considered to be extremely negative. In our opinion, such a view is superficial and does not reflect reality. Sovereign debt should exist, and its place and role are well established.

First of all, sovereign debt allows the funding of states, while a budgetary imbalance is often recorded. Of course, it is essential in this context that the funding can provide economic growth, so that the debt repayment can be achieved without major problems. Also, we emphasize here that the debt to GDP ratio should remain stable over time, a fact unfortunately often contradicted by practice. The upward trend has been a very significant one; of course, sometimes this evolution is fully justified, but many exceptions are recorded; as emphasized by some authors (Landau; 2012, 214), it is normal for future generations to pay for infrastructure or technology now requiring massive investment in research and development, but it is at least incorrect for descendants to pay for the current public consumption, for example.

Sovereign debt often takes the form of bonds issued by states. From this point of view, we are dealing with assets, often very appreciated by investors. For many decades, these assets were considered as risk free. Currently, however, sovereign risk can not be ignored, even if states maintain their ability to increase taxation or to issue currency (the limits are increasingly apparent in this context – for example, the situation of countries that are part of an economic and monetary union). A function of sovereign debt associated to sovereign bonds is storing value – we can speak about a sovereign debt market, with often surprising developments, with more or less liquid areas, depending on the characteristics of states, their economic performance, or even rating.

States must always take into account the preferences of private actors in this regard, the issues being related to public preferences for different maturities (Turner; 2011, 74).

One thing appears to be obvious, however: the lack of financial assets with high liquidity and low associated risk. And this, while the demand for such assets is increasing. But, sovereign debt really represents a low risk asset, as seen for a long time? And most importantly, how it will be in the future? Developed countries are still characterized by a high solvency? What influence will have the budgetary discipline, so necessary today, on sovereign bonds issues? Here are some questions that will have to find clear answers in the near future.

2. SOVEREIGN DEBT – NEW MEANINGS AND FACTS

Sovereign indebtedness and especially over indebtedness is certainly a scourge of the modern world. The developed countries of the world have reached, from this point of view, a level of sovereign debt to GDP of over 100%. Of course, this relative expression has its limits, but seems to be the most heavily used by analysts; by comparing sovereign debt to GDP, *we compare it to the wealth created within a State, wealth created by the state itself, but also by households and businesses* (Garello, Spassova; 2006, 3). This does not allow a perfect understanding of governance quality, but better depicts the magnitude of the phenomenon.

For about seven years, the word crisis seems to have become very often used in economic analysis and it actuality persists today. Undoubtedly, during all these years we have witnessed not a single financial crisis, but a succession of crises following the direction *financial crisis - economic crisis – sovereign debt crisis*.

At the end of the first decade of the new millennium, the global financial system crisis (especially the Western one) claimed a strong intervention from the states. The reaction came, sooner or later, with more or less pro-cyclical effects. Among the measures that were taken, we can mention the support offered to banks and to economic activity in general, in the context of the severe decline in global demand. But policies that allow economic revival have also adverse effects, such as recording significant budget deficits. From this point of view, a trend has emerged in recent years – private indebtedness had a tendency to stagnation, while the public debt has increased significantly.

Many authors argue that the developments of 2008-2009 represent the start of the sovereign debt crisis; desiring to develop a little bit the subject, we think that the onset of the financial crisis and its global manifestation favored the development of the sovereign debt issues, but they are much older.

Moreover, sovereign risk was always present in the economy, being even one of the oldest "components" of country risk. Country risk is often associated with the political, sovereign, systemic, transfer or market risk.

The global financial and economic crisis has forced governments to react, to adopt economic policies that stimulate economic growth and revival. On the other hand, the governments went even further, taking over some risks from the private area; an example is the transfer of risk from the banking sector. Undoubtedly, public finances had been degraded, public debt sustainability being also seriously affected.

An interesting analysis of sovereign debt could be achieved not only by reference to GDP, but also to exports or state incomes. Of course, in such a logic... we would assimilate the state to a private enterprise. The differences are however notable, one being that a state is sovereign and can tax its "subjects".

The manner in which various investors began to perceive the state as a borrower has changed dramatically in recent years. To this mutation has contributed significantly the attitude – sometimes pro-cyclical – of rating agencies, which operated several degradation of sovereign ratings, having as an effect, obviously, the explosion of interest rates levels required by investors.

As we pointed out above, we will not say, however, that the current sovereign debt situation is a direct consequence of the global financial and economic crisis; the public debt increase occurred almost constantly for more than five decades, so the issue is not new at all. Of course, some explanations of the phenomenon can be identified – the public sector development in recent decades, the state maintaining an important role in the economy, the need for social policy, and many others.

Several sources (Banque de France; 2012, 5) emphasize that the effects of these phenomena have not been felt for some time, due to a still lower share of the deficit / debt to GDP ratio. In other words, the indicators degradation occurred in time, and was extremely difficult to identify for a while.

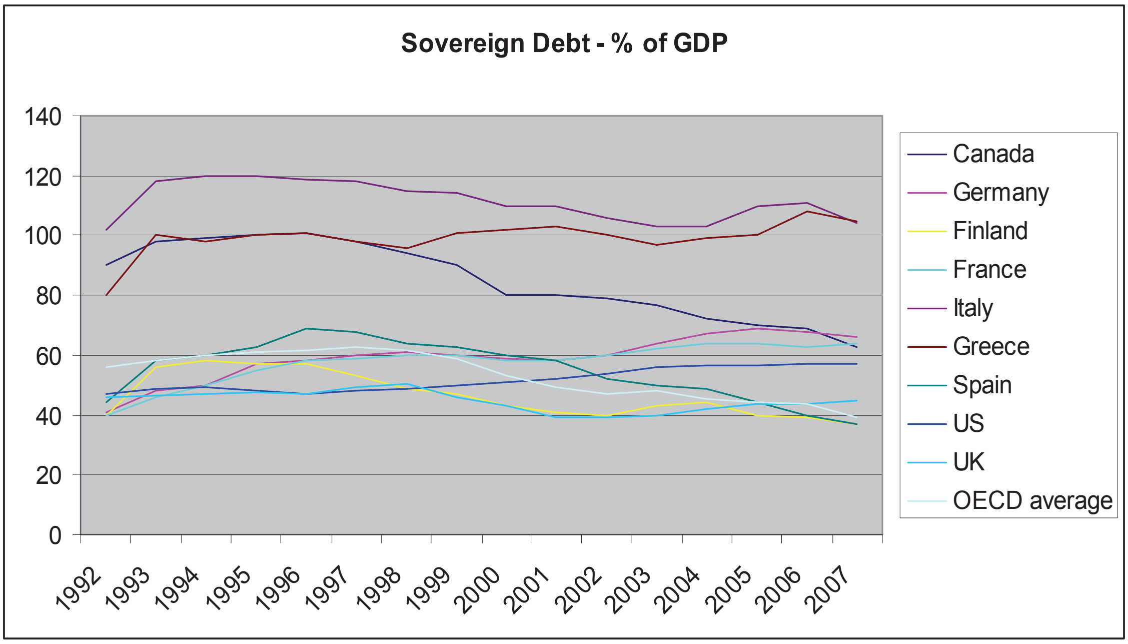
On the other hand, in the past, inflationary episodes could act as a counterweight to the increase in size of debts, and real interest rates close to zero or even negative were able to limit their development. But the last two decades have brought a more rigorous inflation targeting and control, and, in the context of weak economic growth, imbalances have emerged.

An overview of the performances of different states (EU and others) in recent decades reveals that roughly governments have not obtained "profit" for a long time; for example, in France, the "enterprise state" obtained a "profit" for the last time in the early 1970s (Garello, Spassova; 2006, 6). Even in years when the indicator sovereign debt / GDP declined in comparison to the previous year, sovereign debt in absolute value continued to grow. In this context, many of the commitments made in the traditional way by states, such as those in the field of social protection, have become increasingly difficult to meet. In the early 2000s, during the period preceding the crisis, some countries have managed to reduce sovereign debt to GDP (for instance Spain, which also managed to achieve an economic growth above the EU average), but in general the indicator exceeded 60% for most economies.

It is clear, therefore, that on the eve of the global financial crisis the different countries of the world were largely indebted, the problem being one of a structural nature, and the various commitments (Stability and Growth Pact in the EU, the Maastricht Treaty, and others) had lost the initially established significance.

In 2008, developed countries recorded a relatively high public debt – the Euro area average was around 65-70% of GDP (Greece already exceeded 100% of GDP, France was over 60% since 2003, Italy also exceeded 100%,) Japan was situated around 170% of GDP and the US exceeded 60%.

Figure 1 – Sovereign debt evolution before the economic and financial crisis (% of GDP) – selected states



Source : Author's calculations, using data from IMF, *World Economic Outlook*, 2012, and World Bank.

The period that preceded the global financial and economic crisis can thus be characterized as one of increased indebtedness, or even over-indebtedness. After 2008, however, governments were placed in an even more difficult situation. The collapse of private indebtedness and demand led to a significant degradation of budget balances; already indebted, with uncertain growth prospects, many countries have become, as emphasized several authors (Brender, Pisani, Gagna; 2013, 3), unable to maintain a significant budget deficit without endanger the solvency.

The collapse of private agents appetite for debt was proportional to the propensity towards it before the crisis; in the EU, for example, it was significant in Ireland and less evident in Germany. Lending was quasi-stopped, private saving exploded and deflationary effects became imminent.

Of course, avoiding borrowing in such a situation would have been harmful to the stimulation of economic activity; therefore, governments have borrowed even more, at least for a while. From this perspective, it becomes increasingly important to discuss about the sovereign debt sustainability. The visions of governments were slightly different in recent years – European officials have explicitly fixed as a target the return to budget balance, while the United States stayed focused on growth; Japan took a similar approach, and the country continues to have a huge public debt. However, since private savings surplus partially absorbs this debt, and the Japanese economy remains extremely strong, the asian state continues to benefit from relatively low interest rate loans.

For Europeans the situation is delicate, primarily due to the special architecture of the European Union – we are not dealing with a state or a federation, but with Member States that are sovereign and independent, but nevertheless transferring significant powers from the national to the supranational level. So, the problems of a member state (Greece, for example, although it is not the only European country in a delicate situation) seriously put in discussion the opportunity of solidarity (especially financial one) between union member states. In the same time, spillover effects have been there, and the sovereign debt crisis is a European one, first of all; the PIIGS episode can also be evoked here.

Some voices repeatedly highlighted the idea of a Euro currency crisis; however, we believe that it is not a crisis of the Euro currency, but one generated by the behavior of national governments. The European currency has proved – during its existence – to be viable, well received by the international markets, a stable currency, widely used internationally – in other words, all of the attributes of a successful currency.

After 2008, supporting demand involved extensive budgetary measures, in most countries of the world, as we outlined above. Even so, the recession could not be avoided, and the 2007 activity level was reached only in 2012.

These measures, however, significantly affected the budget deficits; we can talk here about the side effects of the economic recovery plans, the increased public spending (for social purposes, for example), the significant reduction of fiscal revenues, the lower gross domestic product.

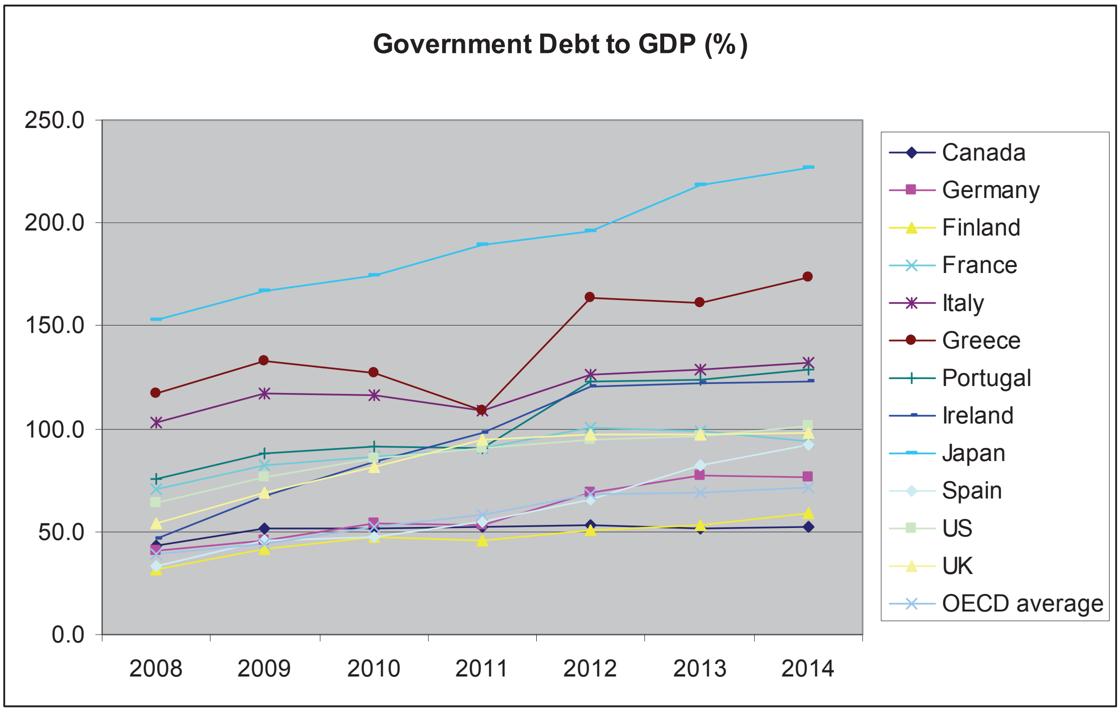
Undoubtedly, the economic recovery measures taken have had considerable effects, and succeeded in part to eliminate, at least in the short term, the negative effects of the crisis. In the medium and long term, consequences are however difficult to predict. Some analysts talk about some contradictory effects (Banque de France; 2012, 12), for example in the case of households. If in a crisis situation households face a shortness of credit, and therefore are unable to modulate their consumption over time, they will tend to immediately consume the additional revenues provided by the budgetary relaunch, thereby enhancing their efficiency; at the same time, however, if a future tax increase is expected, in order to finance deficits, households will save a substantial part of the additional revenue generated by the relaunching policy, reducing the magnitude of the expected effects.

Another set of government interventions made in recent years aimed to assist the banking sector, through state guarantees, capital injections, and other actions.

All these developments have marked significant changes of sovereign risk indicators, which we will summarize in the table below. For OECD countries, the public debt problem turns out to be extremely serious; after the crisis, the true extent of the developed countries indebtedness was highlighted by a drastic decrease in budget revenues.

For some countries, this will be extremely difficult to manage politically and socially, as it requires important decisions concerning the reallocation of national income, subject already delicate due to the effects of the crisis; and, as we all know, the political element is strongly influenced by social reactions.

Figure 2 – Sovereign Debt evolution after the Crisis, selected states (percentage of GDP)



Source: Author's calculations, using data from BNP Paribas, World Bank, www.tradingeconomics.com.

Table 1 – Governmental Debt evolution, selected states (% of GDP)

Country/year	2008	2009	2010	2011	2012	2013	2014
Canada	43.0	51.3	51.5	52.5	53.5	51.9	52.3
Germany	41.0	46.0	53.7	53.3	69.0	77.0	76.0
Finland	31.9	41.2	47.0	45.9	51.0	53.2	59.0
France	70.9	82.6	86.4	90.6	100.1	99.0	93.6
Italy	103.4	117.1	115.9	108.9	126.2	128.5	132.1
Greece	116.8	133.2	127.0	108.7	163.5	161.0	174.0
Portugal	75.9	87.9	91.4	90.2	122.8	124.1	129.0
Ireland	46.8	67.0	83.7	97.8	120.5	121.7	123.3
Japan	153.0	166.8	174.7	189.5	196.0	218.8	227.0
Spain	33.5	45.5	47.1	54.6	66.0	82.4	92.1
US	64.0	76.3	85.5	90.2	94.3	96.2	101.5
UK	54.3	68.6	81.2	94.6	97.2	97.5	98.2
OECD average	39.4	44.1	52.6	58.2	67.9	69.0	71.3

Source: Author's calculations, using data from BNP Paribas, World Bank, www.tradingeconomics.com.

3. SOME ASPECTS CONCERNING SOVEREIGN DEBT SUSTAINABILITY

The evolution of sovereign debt is obvious, its increase during last years is significant, both for developed and developing countries. Of course, the sovereign debt has evolved differently from country to country, from region to region, but the remark can be considered as a general one. Anyway, it is not the debt itself that we consider the most concerning, but rather debt sustainability.

We can also notice that the developed countries took advantage of the low interest rates available for them, and this practice contributed to the accumulation of debt. Of course, we will not say here that indebtedness is synonymous with a total lack of government responsibility, but we believe that economic theory recommending state intervention in order to stimulate growth was not the only one behind these decisions. Several authors even talk about a political, electoral connotation of indebtedness (Garello, Spassova; 2011, 25).

Analysts talk more and more about the bankruptcy of a state nowadays, although technically this is relatively unlikely, given the *sovereign status* of the debtor. What really interests us is the risk of default; is debt sustainable or not, and will it be followed by default – or, in some cases, restructuring or moratorium.

As stressed by many economists, such as Jean-Pierre Landau (Landau; 2012, 16), most often the economic literature is search for a categorical answer to the question of sustainability – the debt is sustainable or not. In practice things are much more complicated, and even influenced by political factors – the states attitude towards markets (governments are "market friendly" or not / the "willingness to pay" matter).

Often, debt indicators (most notably the total external debt / GDP) are used to determine thresholds of indebtedness, thresholds above which default becomes imminent. This practice is extremely useful, and we made such exercises in other works, but we would like to point out here the limits of such an analysis. World states behave very differently, and a given level of debt can be perfectly sustainable in one state, and totally unsustainable in another. Economic history has recorded situations where states having a level of the sovereign debt / GDP ratio of 200% continued to repay their debt, while others went into default at 40-50% or even less.

Also, the he sovereign debtor myth must be regarded with skepticism – during the 1998 Russian crisis, for example, private companies continued to repay, while the state has refused to do it at a certain point.

Relative to the sustainability of sovereign debt, we can make several remarks:

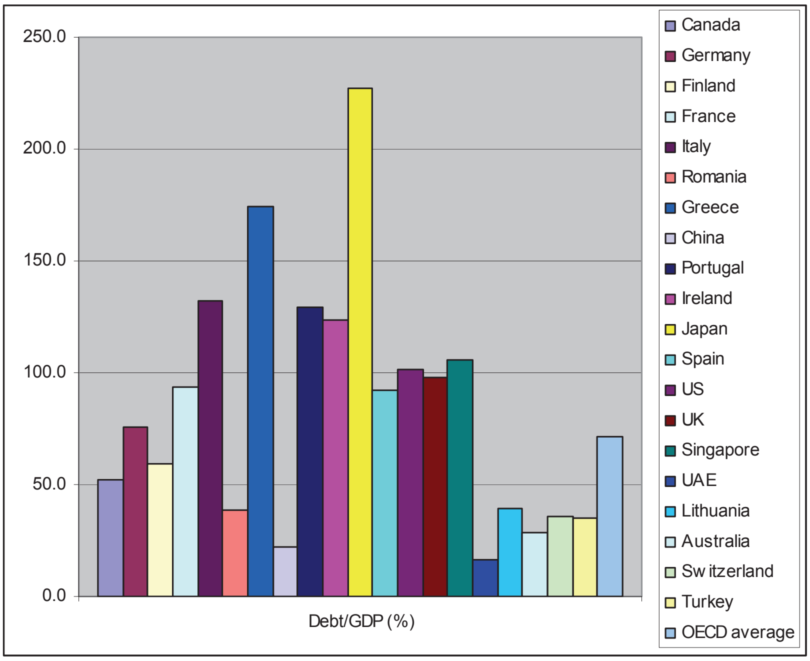
- The point from which debt becomes unsustainable varies from borrower to borrower;
- Sovereign debt sustainability is overwhelmingly influenced by the economic policies; we can give some examples in this context – a state that encourages exports and international trade in general will increase its chances to repay smoothly, especially if indebted in foreign currency; also, policies concerning the control public finances, in order to eliminate budgetary drifts and a clear expression of the desire for debt repayment will positively influence credibility and sovereign rating;
- Growth prospects are essential when talking about sustainability – a state with significant economic growth has all the prerequisites for a refund without problems, but at the same time, indebtedness may affect growth, as evidenced by several recent studies that converge towards stating that the negative effects on economic growth increase when the sovereign debt is approaching 100% of GDP (Reinhart, Rogoff; 2010, 23); as shown in the table and graphs below, heavily indebted states and those that are generally recording lower rates of growth:

Table 2 – Economic growth rate and Debt/GDP ratio (selected countries)

2014	Debt/GDP (%)	Economic growth rate (%)
Canada	52.3	1.6
Germany	76.0	0.5
Finland	59.0	0.3
France	93.6	0.3
Italy	132.1	0.1
Romania	38.4	3.5
Greece	174.0	-3.8
China	22.4	7.4
Portugal	129.0	-1.8
Ireland	123.3	0.6
Japan	227.0	2.0
Spain	92.1	-1.3
US	101.5	1.6
UK	98.2	1.8
Singapore	105.5	4.1
UAE	16.7	4.0
Lithuania	39.4	3.4
Australia	28.6	2.5
Switzerland	35.4	2.0
Turkey	34.8	3.8
OECD average	71.3	0.8

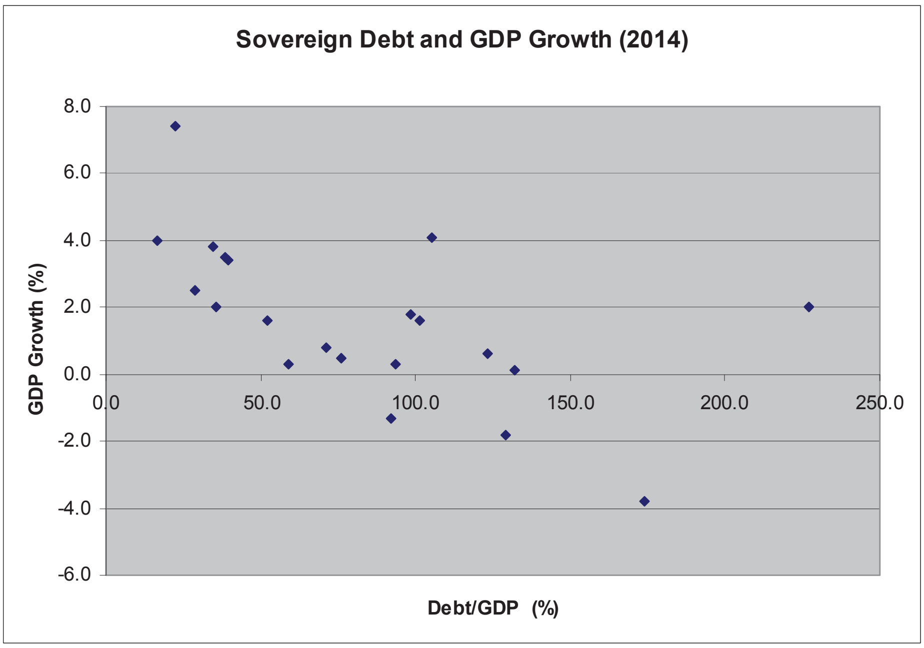
Source: Author's calculations, using data from Eurostat, World Bank, www.tradingeconomics.com.

Figure 3 – Debt/GDP (%) (Selected countries)



Source: Author's calculations, using data from Eurostat, World Bank, www.tradingeconomics.com.

Figure 4 – Sovereign Debt and GDP Growth (2014), selected countries



Source: Author's calculations, using data from Eurostat, World Bank, www.tradingeconomics.com.

- Debt sustainability is strongly influenced by the activity of rating agencies, and the functioning of financial markets; in this context, we should highlight the problems related to the pro-cyclical effects of rating, or to the inefficiency of markets. If, for a relatively long period of time, fragilities could not be identified, the reaction during the crisis was, in our opinion, oversized, increasing eventually sovereign risk; the pro-cyclical influence of evaluations caused partially the spectacular rise in the cost of funding for states with difficulties, but also the emergence and maintenance of a climate of mistrust regarding the solvency of these states.

4. CONCLUDING REMARKS, IDEAS FOR A BETTER GOVERNANCE IN THE CONTEXT OF SOVEREIGN OVER INDEBTEDNESS

The statistical data clearly show that the sovereign debt has now become a real problem, given that it reached a record level for many countries of the world. Much of it is owned by non-residents, and many countries are forced to borrow in foreign currency.

- Also, in many cases, governments borrow only to repay old debts, and sustainability, as well as the impact on future economic growth, are subject to uncertainty.
- Surprisingly, the excess of debt seems to affect more developed countries. Governance is, in this context – today more than ever – put under scrutiny. Sovereign debt sustainability depends largely on economic policies and measures taken by the authorities. Of course, there are a number of external factors, but their influence is not overwhelming.
- Regarding the outlook for sovereign debt, we will make the following remarks, not without leaving room for further studies and developments:
- The will of authorities to repay must be well outlined, in order to restore confidence;
- The purchase of securities by central banks (see the case of the ECB) should not take away them from the traditional objectives; of course, such practices are sometimes welcome, counteracting the liquidity crises, deflation, or *carrying out the monetization ensuring the solvency of the sovereign issuer* (Landau; 2012, 219);

- Ensuring economic growth on different channels, as well as the intensification of international trade and exports in particular can have positive effects on the sustainability; recording some outstanding economic results helps maintaining sustainability even in a context of massive debt;
- The use of ratings should be done with care, in order to avoid misinterpretations; the subjectivity, the conflict of interests or even the error can be associated with the activity of rating agencies, despite their notoriety;
- The sovereignty of states still allows fighting liquidity crises through "injections" of "fresh" money (although more and more countries lost this lever, for example European countries that are part of economic and monetary union – but they retain full sovereignty in matters of taxation); however, the effects on inflation can be dangerous, and such practices are not recommended; but what is clear is that monetary union member states are more exposed to sovereign risk than others – a good example is represented by the states on the periphery of the Eurozone;
- The need for a better control of public spending, which has exploded in recent years, exceeding for many countries the growth rate of GDP; as we have seen in recent years, the cost of financing sovereign debt is rapidly increased by the degradation of the state public finances;
- Orienting a more significant fraction of debt towards investment, given that very often states are borrowing in order to ensure current expenses or to repay older debts; it is also obvious the need to increase public investment profitability, and, why not, to question the role of the state in the economy.

What interests us particularly when addressing the issue of public debt sustainability is its current level, but also the relationship between the interest rate (and debt service in general) and growth prospects (growth rate of real GDP), and the state tax income compared with the public expenditure.

We believe that the sustainability of sovereign debt is a concept that should be viewed dynamically; what matters first is the ability of governments to ensure the future debt service. Quantifying this capacity is always a challenge because future state revenues and spending can not be predicted accurately.

When we intend to identify the level from which debt becomes toxic, dangerous, we can be very creative, setting alert thresholds or introducing more or less complex indicators (from the classic public debt / GDP ratio or Government debt / exports, to the more elaborate indicators, aiming for instance institutional quality).

As highlighted in some recent books (Brender, Pisani, Gagna; 2013), studies (Minea, Parent; 2012) and papers (Reinhart, Rogoff; 2010), the level of debt from which onwards there is an imminent danger of default is difficult to identify and, on the other hand, impossible to generalize. More suitable is to set thresholds above which sovereign debt implies adverse consequences of economic life; from this point of view, most of the papers identify an alert threshold around 90-95% of GDP. Above this value, growth seems to be difficult, if not impossible, to achieve.

The current situation, the sovereign debt crisis, is not a disaster in itself. Rather, it is a warning, a lesson to be learned and well understood, than can definitely serve to improve governance.

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